Paula Conboy, Chair
Michelle Groves, CEO
Australian Energy Regulator
By email

Tuesday 17 March 2015

Dear Ms Conboy and Ms Groves,

Removing barriers to demand management

The undersigned energy consumer and other advocacy organisations are writing to outline our concerns over the current barriers to demand management (DM) and the Australian Energy Regulator (AER)'s approach to DM plans and incentives in the current round of regulatory determinations, as well as to make some suggestions for reform.

We are aware that the AER is in a difficult position, given that the Australian Energy Market Commission (AEMC) has not completed the DM incentive scheme rule change process, but would like to see the AER give greater priority to DM in its determinations and more generally, for the long term interests of consumers. We are also communicating with the network businesses directly, with the AEMC and others to enable and support the uptake of DM opportunities.

The benefits of DM are recognised in the National Electricity Rules (the Rules),[1] by some network businesses,[2] and by the AER itself.[3] However, as you are aware, the performance of many networks in the National Electricity Market (NEM) in relation to DM outcomes has to date been very poor by international standards, with current DM being equal to less than two per cent of NEM-wide peak demand and only about one per cent of the generation capacity in the NEM. The AEMC has identified substantial DM opportunities which could lead to savings of $4 to $12 billion over the next ten years. These savings, if passed on to electricity consumers, could result in annual bill reductions of between $120 and $500.[4]

A range of regulatory and other barriers is limiting the timely identification and implementation of DM opportunities by networks. Some of these barriers (especially the cultural mindset within the network businesses) are beyond the control of the AER, but we are concerned that the AER is not taking full advantage of the regulatory levers currently available to it. This is particularly in relation to the application of Clause 6.6.3, *Demand management and embedded generation connection incentive scheme* (DMEGCIS) of the NER in the current round of distribution network revenue determinations.

Should the AER's recent approach to DM continue throughout the current round of revenue determinations, the NEM's already poor DM performance is likely to actually reduce even further until 2019 at least. We consider it important to ensure that this does not occur.

The AER's approach to DM in revenue determinations

The issues as we seem them are summarised as follows:

1. *The $1m cap on Part A of the existing DMEGCIS:* In the previous and current revenue determinations, the AER has consistently imposed a limit of $1 million per year for the demand management incentive allowance (DMIA) although there is no statutory requirement to do so.[5] This appears to have led to the DMIA functioning as an arbitrary cap

on innovation, rather than encouraging it. Also, the AER does not appear to provide networks with clear and consistent advice about how past DMIA projects should be measured and reported on, or what it regards as innovative DM, and how innovation should be mainstreamed into business as usual.

2. *Lack of an incentive scheme for DM:* To date the AER has used Part B of the DMEGCIS only to allow networks to recover revenue foregone under Part A, where networks have been subject to price caps. In the past it has claimed that it lacks sufficient direction from the Rules in order to implement a broader scheme that would provide genuine incentives to networks as an a alternative to the capex bias in the Rules, even though the Productivity Commission and the AEMC both recognised that sufficient scope does already exist for the AER to introduce a broader incentive scheme.

   In an attempt to provide stronger support for the AER's role, the Total Environment Centre (TEC) and the Council of Australian Governments (COAG) Energy Council submitted proposals for reform of the DMEGCIS to the AEMC late in 2013. Unfortunately, the AEMC only started consultations on these proposed rule changes recently. In the interim, in its draft determinations for New South Wales (NSW) and Australian Capital Territory (ACT) networks, the AER has quite reasonably removed the existing D-factor scheme as it will not be relevant as these jurisdictions move to a revenue cap. However, in the absence of alternative incentives such as Ausgrid's proposed DM benefit sharing scheme, 'this draft decision is less supportive of demand management than the previous AER decision.'[6]

3. *Expectations around DM not clear in AER documents:* With regard to process, the AER has failed to signal through the Framework and Approach and Issues papers for each jurisdiction that it regards DM as an integral part of capex and opex plans, instead referring only to the DMIA, the removal of the D-factor and the possible interaction between a DMEGCIS and other incentive schemes (Efficiency Benefit Sharing Scheme and Service Target Performance Incentive Scheme). The idea of capex-opex trade-offs or a de facto benchmark for DM spending has not arisen until the draft determinations.

4. *Networks not presenting clear DM proposals or lists of DM projects:* Most networks have submitted DM programs that are buried deep in their thousands of pages of documents, inconsistently presented and difficult to compare.[7] Further, there appears to be no requirement for networks to list any DM projects, let alone to explain how non-network options have been considered and rejected. This makes it very difficult, if not impossible, to assess whether DM and other non-network options have been adequately considered as alternatives to the new augmentation and replacement capex projects in regulatory proposals.

5. *Seemingly inconsistent requirements around benefit-cost ratio requirements for DM:* In its draft determinations for the NSW networks, the AER discussed applying Ausgrid's achievement of a 2.5:1 benefit to cost ratio for its past DM program to the capex/opex trade-off in the next period. We are unsure why the AER is requiring a benefit to cost ratio that is higher than would be required for other programs to be economically efficient (ie, anything greater than 1:1).

6. *No allowance for opex trade-offs:* The AER has reduced Ausgrid's capex proposal without correspondingly allowing it to recover business-as-usual DM spending through its opex allowance.'[8] On the other hand, the AER has decided 'to not include an explicit reference in the capex or opex forecasts for demand management'[9] for Essential Energy and Endeavour

Energy. This sends a signal to networks that there is no established mechanism or methodology for capex-opex trade-offs, and therefore that the AER does not support 'business as usual' DM.

7. *Assumption that cost-reflective pricing will have the same impact as DMIS reform:* The AER has also rejected Ausgrid's proposal mentioned above on the basis that the benefits would not occur until late in the regulatory period, by which time the introduction of cost reflective pricing would deliver price signals enabling customer response sufficient to undermine the business case for broad-based DM.[10] There are several fundamental flaws with this approach, including: (a) that the benefits of cost reflective network tariffs are uncertain (particularly given the lack of smart meters in states other than Victoria) and may be complementary to (rather than replicating) DM programs; (b) that DM programs can be targeted to areas of localised network constraints, while broader cost reflective tariffs may not be; and (c) that networks should be able to spend opex on DM in one revenue period with some benefits occurring in the next period.

Suggestions for reform

We suggest that the AER could do more to support and promote DM as a tool to lower peak demand and thus retail bills by instituting some or all of the following reforms:

1. In current and future regulatory determinations, by benchmarking DM performance in relation to the appropriate capex-opex trade-offs and benefit to cost ratios, including allowing DM opex where it is anticipated to result in capex savings (with a positive Net Present Value), whether or not these savings are in the same regulatory period.
2. In the forthcoming regulatory determinations for Victorian and Tasmanian distributors, by sending a much stronger and more consistent signal about the importance of DM in constraining proposed augex and repex spending from the outset, in its Position, Framework and Approach and Issues papers, rather than limiting discussion to the planned application (or non-application) of the DMEGCIS.
3. In all current regulatory determinations, by allowing greater than $1 million per annum expenditure on the DMIA where it is likely to be genuinely innovative and accompanied by a robust measurement, verification and reporting mechanism.
4. By developing a DM Guideline, setting out its expectations of networks in relation to regulatory determinations (not only in relation to regulatory incentives but also capex-opex trade-offs, the presentation of data and DMIA plans), the annual reporting of DM spending and results, and the appropriate consideration of non-network options in RIT-Ds.
5. By supporting the TEC/COAG DMEGCIS rule change process and ensuring that it is implemented via amendments to all 2015-19 distribution network determinations as soon as practical after it has been finalised.

We would appreciate the opportunity to discuss these concerns and proposals with you, and to engage with AER staff in bringing these and other demand management reforms to fruition as soon as possible.[11] Our initial contact person for this engagement is Mark Byrne, Energy Market Advocate, Total Environment Centre (0403070442, markb@tec.org.au).

Yours sincerely,

Jeff Angel
Executive Director
Total Environment Centre
On behalf of the following organisations:

[1] 'The extent the DNSP has considered, and made provision for, efficient and prudent non-network alternatives' is one of the capex and opex factors to be considered by the AER under in making its revenue determination.

[2] The revenue proposals from Ausgrid, Ergon and Energex in particular include reasonable DM plans. SA Power Networks, on the other hand, has conspicuously ignored DM.

[3] AER, Draft Decision Ausgrid: Appendix 6 Capital Expenditure, November 2014, 83.

[4] Dunstan, C., et al, *Restoring Power: Cutting bills & carbon emissions with Demand Management,* Institute for Sustainable Futures, University of Technology Sydney, 2013, 5.

[5] The Productivity Commission's 2013 *Report on Electricity Network Regulatory Frameworks* recommended that 'in the short term, unless other changes are made to the DMEGCIS to encourage demand management, the innovation allowance should be increased'.

[6] Ausgrid revised regulatory proposal - Attachment 5.14, 7.

[7] We note that SA Power Networks has not submitted a proposed DM program at all.

[8] Thus Ausgrid, for example, has not been allowed to spend $22 million of opex on its broad-based DM strategy even though 'a positive NPV is returned in 6.5 years and the total NPV (10 year) through to 2024 is $31 million': Ausgrid revised regulatory proposal - Attachment 5.14, 8.

[9] AER, Draft decision, Essential Energy distribution determination 2015–16 to 2018–19, Attachment 6: Capital expenditure, November 2014, 6-79.

[10] AER, Draft Decision Ausgrid: Appendix 7, Operating Expenditure, November 2014, 7-168.

[11] For instance, we also consider that there are serious issues with the design and implementation of the regulatory investment tests (RITs) that require reform.